

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 07-0677; 07-0678; 07-0679
Gross Retail and Individual Income Tax
For the Years 2004 and 2005**

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Calculation of Taxpayer's Gross Retail Tax Liability Based Upon the Best Information Available.

Authority: IC § 6-8.1-5-1(a); IC § 6-8.1-5-1(b); IC § 6-8.1-5-4(a) 45 IAC 2.2-6-8(a); 45 IAC 3.1-1-66.

Taxpayer protests the audit's determination, based upon a "best information available" assessment, that taxpayer is liable for an additional amount of unpaid gross retail (sales) tax. Taxpayer argues that, based upon more recent sales figures, it is possible to determine a more accurate – and lesser – sales tax liability.

STATEMENT OF FACTS

Taxpayer is an Indiana business organized as an S-Corporation. Taxpayer owns and operates a tavern. Taxpayer sells beer, liquor, food, and other related items. Taxpayer operates a pool table, juke box, and illegal "Cherry Master" gambling devices.

The Indiana Department of Revenue (Department) conducted an audit review of taxpayer's records for 2004 and 2005. The audit found that taxpayer had failed to maintain complete sales records and concluded that taxpayer earned additional retail income in the form of unreported sales because taxpayer's records of its gross retail sales were unreliable. Thereafter, the audit resorted to an on-line resource called BizStates.com to determine that taxpayer's "cost of goods sold" constituted 43 percent of taxpayer's total sales. Because taxpayer is organized as an S-Corporation, the determination that taxpayer earned additional sales income during 2004 and 2005, the audit also found that taxpayer's two shareholders accrued additional taxable income during 2004 and 2005.

Taxpayer disagreed with the audit's conclusion and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative elaborated on the basis for the protest. This Letter of Findings results.

DISCUSSION

I. Calculation of Taxpayer's Gross Retail Tax Liability Based Upon the Best Information Available.

A. Sales Tax.

Taxpayer protests the determination of its sales tax liability for 2004 and 2005 because it claims that the audit should have relied exclusively on taxpayer's "daily sales" records, that the audit erred by relying on information obtained from BizStates.com, and that taxpayer's tavern business is not comparable to similar local establishments.

45 IAC 2.2-6-8(a) states that "[i]n determining the retail merchants' tax liability for a particular reporting period, the retail merchant shall multiply the retail merchant's total gross retail income from taxable transactions made during the reporting period" The rule is straightforward but complicated by the fact that reliable source records of the taxpayer's taxable transactions were not preserved. In those situations in which the taxpayer has not maintained adequate records, the Department is authorized to reach an assessment based upon the best information available. IC § 6-8.1-5-1(a) states that "[i]f the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on *the basis of the best information available.*" (*Emphasis added*). The Department made such an assessment by considering published information at BizStates.com, the available records provided by the taxpayer, and the Department's own past experience and practices with similar previous audits.

The initial audit determination of taxpayer's liabilities arrives with a presumption of correctness. IC § 6-8.1-5-1(b) states that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Each taxpayer is required to maintain records sufficient to determine the amount of tax due. IC § 6-8.1-5-4(a) reads as follows:

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine that tax, including invoices, register tapes, receipts, and canceled checks.

Plainly, taxpayer failed to maintain the original source documents as required in IC § 6-8.1-5-4(a). Plainly, the audit was justified in relying on the "best information available" to adjust taxpayer's reported sales when taxpayer failed to preserve the "source documents" consisting of original cash register receipts. There is little to recommend

taxpayer's bare assertion that the resources or methodology relied upon by the audit are inherently flawed.

However, taxpayer maintains that the audit's conclusion – that taxpayer's "cost of goods sold" is 43 percent of taxpayer's total sales – is flawed and that the "cost of goods sold" is actually closer to 67 percent of its total sales. In support of that conclusion, taxpayer offers copies of its "daily sales sheets," copies of the monthly ST-103 sales tax returns, and the general ledgers for 2005, 2006, and 2007.

In addition, taxpayer has offered anecdotal evidence in support of taxpayer's assertion that its "cost of goods sold" is 67 percent of its 2004 and 2005 total sales. Taxpayer explains that it has kept the retail price of its food items low because it was unable to "achieve price breaks on bulk purchases" and that it "orders food in smaller containers at significantly higher costs for the convenience of its employees in preparing and providing the various food items to purchasers." Additionally, taxpayer suggests it keeps its alcohol and food prices low because it competes with five nearby non-profit organizations and that the Indiana county in which it is located is "one of the most economically depressed counties in Indiana"

Taxpayer has not met its burden of demonstrating that its 67 percent "cost of goods sold" calculation is correct because taxpayer bases its calculation on the same methodology and inadequate records which the audit originally rejected. However, taxpayer offered substantive evidence indicating that its 2007 "cost of goods sold" was approximately 55 percent. The Department is prepared to accept the 55 percent calculation because taxpayer indicates that the 55 percent figure is based upon original source documents – cash register receipts – which it retained for 2007. The Department is prepared to accept the implied assertion that the 55 percent figure can be extrapolated to reasonably calculate taxpayer's gross retail sales for 2004 and 2005.

B. Shareholder's Income Tax

Because taxpayer is an S-Corporation, the adjustment to taxpayer's gross retail sales had a direct effect on the shareholder's Indiana income tax liability. With the increase in taxpayer's gross retail sales, the shareholder's Indiana income tax liability increased. Taxpayer makes note of this latter adjustment and – for the same reasons expressed in part "B" above – challenges the income tax assessment.

An S Corporation normally does not pay income tax. 45 IAC 3.1-1-66, states that, "Corporations electing Subchapter S status under Internal Revenue Code § 1372 . . . are exempt from adjusted gross and supplemental net income tax on all income except capital gains" Rather than taxing the income at the business level, the S corporation's income is passed through to the shareholders. The shareholders then must report the income on their own income tax return. 45 IAC 3.1-1-66 states that, "Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate."

For the reasons cited in part “B” above, the shareholders’ income tax should be adjusted to comport with the finding that taxpayer met its burden of demonstrating that taxpayer’s “cost of goods sold” is 55 percent of its gross retail sales for 2004 and 2005.

FINDING

Taxpayer’s protest is denied in part and sustained in part. Taxpayer has not met its burden of proof establishing that the “cost of goods sold” is 67 percent of its gross retail income. Taxpayer has met its burden of proof of establishing that – in the absence of the 2004 and 2005 source documents – the 55 percent “cost of goods sold” is a reasonable figure upon which to calculate taxpayer’s 2004 and 2005 gross retail sales. The audit division is asked to review taxpayer’s 2007 source documents and to make whatever adjustments it deems appropriate both to the gross retail tax assessment and to the shareholders’ income tax assessment.

DK/AB/BK – January 7, 2008